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International financial architecture and development, including net transfer of resources between developing and developed countries

Report of the Secretary-General**

Addendum

Financial stability and market efficiency: a global public goods perspective

Note by the United Nations Development Programme

Introduction

1. In paragraph 7 of its resolution 55/186 the General Assembly requested the Secretary-General, in collaboration with the United Nations Development Programme (UNDP), to provide information at its fifty-sixth session on the analysis undertaken of international financial stability as a global public good. The present note responds to that request. The discussion in the present note is also relevant to the preparations for the forthcoming International Conference on Finance for Development, notably its agenda item on respectively, international financial cooperation for development and systemic issues.[1]

2. The request for the note was sparked by the UNDP-supported publication on global public goods (GPGs), which includes, among other things, a chapter on financial stability as a GPG.[2] This chapter argues that financial crises and the excessive financial volatility they entail constitute a global public bad. They can undermine countries, even if everything is going right at the national level; and their contagion effects can spread indiscriminately, to neighbouring countries as well as across regions. The author

* A/56/50.

** This report was submitted only on 10 July 2001 because some of those invited to comment on the draft were delayed in so doing.

[1] Information about the Conference can be found at http://www.un.org/esa/ffd.

[2] See, Wyplosz, Charles (1999), "International Financial Stability" in: Inge Kaul, Isabelle Grunberg and Marc A. Stem, eds. *(1999), Global Public Goods: International Cooperation in the 21st Century.* (New York: Oxford University Press), pp. 152-189.

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highlights the importance of self-fulfilling crises, i.e. crises that are triggered by information asymmetries and uncertainty, and when a confidence loss occurs, propelled by the herd behaviour of investors (Wyplosz 1999, pp. 161-163).[3] The publication of the book, and notably, that of the chapter on financial stability, engendered a series of follow-up debates, at the country, regional and international levels, within academic, market-actor, civil society and public policy-maker circles.[4] These debates, as well as UNDP's further research on the topic, have demonstrated that examining the issue of financial stability and market efficiency through the GPG lens helps to generate new, policy-relevant insights. The GPG lens draws attention to policy options, which emphasize mutual interest and common concerns as well as pragmatic and practical change, thus strengthening the motivation on the part of all to act and to move ahead.

3. Four policy messages, in particular, stand out:

- In order for the GPG "financial stability and market efficiency" to help to foster the development of all, its design must be anchored in national policy goals and conditions and reflect the diversity of countries, actors and stakeholders.
- Broad participation in international financial policy-making is not a favour but a must to avoid collective-action and information problems.
- The GPG "financial stability and market efficiency" will emerge only if *all* building blocks are in place — its national, regional and global elements as well as required public and private contributions.
- Capacity-building in developing countries is critical to progress in the aforementioned areas and would, most appropriately, be financed out of the seigniorage[5] earned by the central banks of industrial countries.

4. The following sections will elaborate these findings. As suggested in the conclusion, a number of the policy reforms discussed here are already beginning to take place, yet this so far only in an incipient, and often, ad hoc and isolated way. The forthcoming Financing Conference provides an opportunity to integrate these change processes and adjust the global financial architecture to today's development realities and objectives.

I. In order for the GPG "financial stability and market efficiency" to have positive utility and help to foster the development of all, its design must be anchored in national policy goals and conditions and reflect the diversity of countries, actors and stakeholders.

5. Markets are public goods par excellence. They are open to all wishing and able to enter into an economic exchange.[6] In this sense they are non-

[3] It might be useful to present here Wyplosz' distinction between pecuniary and non-pecuniary externalities. The author writes (1999, p. 159): "The world financial market is not just an amazingly powerful institution – it is also a vehicle for powerful externalities. Many of these externalities are pecuniary: country and exchange risk premiums are usually based on an extensive credit rating industry, which monitors, at a cost, economic and political conditions around the world. But even the business of credit rating faces the problem of asymmetric information." And therefore, markets sometimes fail to adequately price risks ahead of time. In addition, as Wyplosz' argument continues, "[...] some externalities are non-pecuniary. For example, as the [1999] crisis occurred in Thailand, markets reacted violently (adverse selection) and indiscriminately, spreading the crisis throughout South-East Asia and beyond to Brazil, Poland, the Russian Federation and several other countries. This externality cannot be priced adequately. There is an emerging market premium, but it fails to take into account the phenomenon of contagion."

[4] For some of the written follow-up contributions, applying the GPG concept to issues of financial stability and market efficiency, see, for example, Camdessus (1999); Development Committee (2001); Eichengreen (2001); International Financial Institutions Advisory Commission (IFIC) (2000); Ocampo (2001); Scholte and Schnable (2001); World Bank (2001).

[5] Seigniorage is the Government's ability to raise revenue through its right to create money.

[6] Of course, markets have access barriers. They can be enjoyed only if a person has something to trade. The poor often have little use for this institution, since they lack purchasing power or the means that would enable them to produce and trade goods or services. However, access problems must be distinguished from the publicness of the good's benefits/costs. Even though they lack access, the poor also have a keen interest in markets, because, if markets collapse, they, too, may be affected and experience wider and deeper poverty. Other market access/entry issues concern the question of licensing, e.g., the licensing of banks. This practice is intended to reduce information asymmetries. Once licensed for particular transactions, actors can freely enter the market.

excludable, and thus, meet the key criterion that distinguishes public from private goods.[7] Markets are also what economists call non-rival in consumption. This means their enjoyment by one person does not diminish their utility for others. On the contrary, market efficiency tends to benefit from expanding market size and diversification.[8]

6. What holds for markets in general also applies to financial markets. For them, as for all other markets, experience has shown that unfettered economic transactions are not necessarily the most efficient ones. Markets benefit from being supported by such public institutions (intermediate goods) as legal frameworks, independent judiciary systems, proper accounting standards and other norms and processes that help to enhance transparency, reduce risks and lower the transaction costs of market participants.[9] Yet, markets are not ends in and by themselves. They are a means, a mechanism for the provisioning of goods. Markets themselves are a good that should feed and help to foster a country's development. Hence, the structure and functioning of markets need to be assessed in terms of their contribution to society's larger goals. As regards financial markets, the key questions in this respect would be, for example, whether the right type of resources flow to where they could be used most productively. Achieving this objective will often not only require an institutional embedding of markets that helps to reduce transaction costs but further public-policy incentives to enable market actors better to combine private and social rates of return.

7. Obviously, to the extent that national borders are made porous by the various processes that we usually sum up with the term "globalization", it will often be desirable for national public policy makers to organize the institutional embedding of financial markets in consultation with other countries. For example, harmonizing national policies with international codes and standards could foster the attainment of national development goals by attracting more external capital to augment domestic resources. Such policy harmonization is one way in which the national public good "financial market" turns into a GPG.

8. Another way is that with increased openness, national financial markets can be affected by cross-border spillovers, negative and positive, emanating from the markets of other countries. As Ocampo (2001, p. 10) noted, under the current conditions the major industrial countries are the "business-cycle/policy makers" and the emerging and as-yet-to-emerge markets the "business-cycle/policy takers". In his words (ibid.), "the center economies generate externalities to the rest of the world that are not internalized by (their) policy makers. These externalities are strongly felt in the developing world, which must adjust to them but lacks the degree of freedom that the ability to supply international currencies provides."

9. As the financial crises of the late 1990s demonstrated, major financial markets can also be affected by, and become jittery as crises occur in developing countries — or put differently, when they permit their financial actors to engage in overly risky, excessive lending abroad. So, externalities move back and forth between different groups of countries, albeit affecting smaller markets typically more severely than larger ones. This demonstrates that making financial markets work in all countries is a shared interest of all. Yet, as we saw before, "making markets work" means making them serve national development purposes.

10. Accordingly, policy makers in all countries (notably those, who at present feel they belong to Ocampo's category of "policy takers") would have to clarify the following five questions in selecting their financial market development strategies: (1) What national development purposes are financial markets to serve; and what type of market institutions and complementary public-policy instruments and mechanisms would the attainment of these objectives require? (2) To what extent can the desired market development be attained through domestic policy action alone? Notably, what can be done in terms of self-protection, i.e., preparing the country to cope with external shocks? (3) What are the costs/benefits of policy convergence towards present international policy recommendations, codes and standards? (4) How can the current international policy and mechanisms be improved so as to make them better serve national goals? and (5) What international (regional and interregional) public policies would be

[7] For a detailed discussion on the theory of public goods, see, for example, Cornes and Sandler (1996).

[8] It is important not to confuse the institution of the market, the public good, with the competitiveness of many market transactions that the institution facilitates, nor with the privateness of the goods typically traded in markets.

[9] See on this point, for example, Lindblom (2001).

needed to do what even the most efficient international financial markets would never do (e.g., to channel financial resources to developing countries falling into the group of as-yet-to-emerge markets)?

11. It is based on the answers to these questions that ideally international cooperation in support of the joint provision of the GPG "financial stability and market efficiency" ought to proceed. Such needs assessments or tests would anchor international cooperation nationally, i.e. in national interests, and foster a bottom-up process of globalization.[10]

II. Broad participation in international financial policy-making is not a favour but a must to avoid collective-action and information problems.

12. Of course, emphasizing national and local self-interest in international cooperation immediately raises the question of how to align the policy priorities of different actors and stakeholder groups: Do we have the right incentive structures and the right type of consultation and decision-making processes?

13. Public good provision, in general, tends to suffer from three sets of problems. The first set concerns the fact that public goods give rise to market failure, because of the non-excludability of their benefits. For example, why would any individual actor pay from her pocket for the creation of a judicial system when she can enjoy it once someone else creates it — for free? Moreover, the costs involved may be too high to be borne by just one actor alone. A second set of problems is known as collective-action problems. Again, the publicness of goods' benefits makes individual actors reluctant to step forward and to volunteer to pay for them, even if the payment in question is linked to a cooperative, shared effort.[11] And third, while at the national level the State often steps in to help to resolve such market failures and collective-action problems, it is itself not immune to failure. Mandates that Governments receive from their electorate do not necessarily translate into corresponding action, a problem known as "government failure".

14. However imperfect, at the national level we have processes in place for all actor and stakeholder groups to reveal their preferences and for Governments to assist them in overcoming obstacles to cooperation. This does not mean that public goods are necessarily State-provided. In today's multi-actor world, the State has, in large measure, been taken out of the direct production of public goods, and to varying degrees, sometimes only offers incentives to nudge private actors along desired policy lines. This also applies to the embedding of financial markets, although many of the required institutions — e.g., property rights, contract law, an independent judiciary — are still best provided by the State. Others, such as technical norms and standards, are increasingly provided, or at least, co-provided by private actors.[12] Yet internationally, there exists no equivalent of the institution of the state. Therefore, reaching consensus among all concerned parties on such issues as which type of policies to converge and which joint international facilities to create is key to an adequate provision of GPGs.

15. Over and above these already daunting challenges, international financial cooperation, however, has to overcome two further constraints. First, several international organizations address

[10] A similar argument is presented by Rodrik (2000), who argues that "economic development ultimately derives from a home-grown strategy, and not from the world market. Policy makers in developing countries should avoid fads, put globlization in perspective, and focus on domestic institution building" (p. 36).

[11] One major type of collective problem is this free-riding: trying to enjoy public goods for free. Another, closely related problem has been described as prisoner's dilemma: In this case, actors are uncertain about the cooperation strategy of their counterpart(s), and therefore, find that irrespective of what the other actor(s) might do, non-cooperation is the most rational choice – entailing no loss, but possibly, if someone else makes a contribution, a free gain.

[12] For example, mention can be made of the International Accounting Standards Commission (IASC).

financial issues[13] fragmenting the overall vision of, and the approach to, ensuring financial stability and market efficiency.[14] Second, as a growing number of studies have pointed out, the composition of the concerned policy-making bodies is biased towards participation of the major-market countries and financial-sector experts and policy makers. The participation and voice of developing countries as well as that of many stakeholder groups is often limited.[15]

16. It seems that the present pattern of consultation and decision-making has repeatedly led to decisions that place an undue burden of adjustment to the *current* financial system on developing countries. For example, while all parties agree on the importance of financial regulation and supervision, some question whether the codes and standards proposed "are suited to the circumstances of the countries to which they apply" (Eichengreen 2001, pp. 8-9) and "what incentives are there for countries to take ownership" (Eichengreen 2001, p. 12). The codes and standards themselves and the reporting on countries' compliance with them are getting increasingly complicated and costly. (See, for example, UNCTAD 2001, pp. 79-107). Quoting Soludo and Rao (1999) as well as Park and Wang (2001), and Eichengreen (2001, p. 12) points out that: "Collecting and processing data and strengthening regulatory and supervisory standards requires technicians and data processors, computer programmers and bank inspectors. However commendable this effort, these investments may come at the expense of programs supporting socially vulnerable groups and, risk eliciting a political backlash in cash-strapped economies." Also, while developing countries are being advised to achieve greater reliance on private finance for development, the New Basle Accord, if implemented as currently suggested, would have significant and broadly negative repercussions for developing countries.[16]

17. According to some analysts (e.g., Griffith-Jones and Cailloux 1999, Ocampo 2001, UNCTAD 2001), it is much rarer to find decisions calling for changes in the global system or in the behaviour of industrial-country actors, although some such steps have been taken.[17] Obviously, where participation of all concerned is lacking, there is a risk that linkages between national and international level initiatives become severed and that the link between finance and development weakens. By now financial policy makers are realizing this problem. A growing number of policy statements stress the importance of enhanced participation of developing countries in international financial decision-making as a means of devising more country-specific, appropriate and effective arrangements. [18]

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[13] The major ones include: the Bank for International Settlements (BIS), which also houses the Basel Committee on Banking Supervision, the Committee on Payment and Settlement Systems, and the Committee on the Global Financial System, as well as the International Association of Insurance Supervisors (IAIS) and the Financial Stability Forum (FSF); the International Monetary Fund (IMF); the International Organization of Securities Commissions (IOSCO); International Accounting and Standards Commission (IASC); plus the World Bank and the regional development Banks; the United Nations Conference on Trade and Development (UNCTAD); the Organisation for Economic Cooperation and Development (OECD); and last but not least, the Gs: G-7/8, G-10, G-20 and G-24.

[14] As Wyplosz (1999, p. 166) noted: "Problems are dealt with ad hoc by groups of concerned countries or professional associations (IOSCO, IASC). Existing institutions (IMF, World Bank, BIS, OECD) spread their domain of intervention, sometimes overlapping with each other, sometimes leaving cracks in between."

[15] For discussion on this issue, see for example: Buria (2001), Culpeper (2000), Helleiner (2001), IMF (2000), Ocampo (2001) and UNCTAD (2001).

[16] In an interview with Griffith-Jones on her study with Spratt (2001), Reuter's David Chance notes that at present, banks are required to set aside nothing against loans to an AA-rated sovereign and just $8 for every $100 of loans to a single-B rated non-OECD country like Argentina. He then quotes Griffith-Jones as saying that "under proposals [as those contained in the New Basle Accord] allowing banks to use an internal system, capital provisioning of 60 cents would be required for $100 for loans to an AA-rated sovereign. But for the likes of Argentina, $50.40 in capital would be required for every $100 of loans." For data supporting this statement, see, among others, Griffith-Jones and Spratt (2001) and Reisen (2001). Further, see also the interview with Willy Zapata, the former president of Guatemala's central bank in the *Financial Times*, 9 June 2001, p. 8 and G-24 (2001).

[17] See on this issue, for example, the report of the FSF Working Group on Highly-leveraged Institutions, which, among other things, calls for enhanced disclosure procedures for these institutions (www.fsforum.org). So far, however, there has been only limited follow-up to the recommended actions.

[18] See, for example, Crockett (2001), Koehler (2001), United Kingdom (2000), chap. 4, and United Kingdom (2001).

18. Clearly, broader participation in financial policy-making should not be seen as a favour. Rather, it is a necessity — a precondition of achieving a balanced global policy regime, one that enjoys the support of all, and therefore, is also likely to be the more effective and efficient one in the longer run. Pragmatic and practical recommendations have been tabled on how participation in financial policy-making could be broadened (e.g., Griffith-Jones 2001; Scholte and Schnabel 2001). But, enhanced participation in international negotiations takes time, effort and money. So, are we caught in a vicious circle?

19. As is discussed in point IV, recognizing the GPG nature of financial stability and market efficiency also helps us to see a feasible way out of this dilemma. Yet, before pursuing this issue further, we will take a closer look at the "production function" of financial stability and market efficiency.

III. The GPG "financial stability and market efficiency" will emerge only if *all* building blocks are in place — national, regional and international-level measures, public and private contributions.

20. A striking feature of today's policy debates on global financial issues is often that various contributors tend to highlight selected aspects, or even, juxtapose national and international measures, industrial and developing country concerns, or private and public inputs. Yet, thinking through what could be called the "production function" of the GPG at hand reveals that all dimensions matter. The key challenge is to bring them together. As we saw in point II, collective-action problems and differences in interest sometimes impede progress in this respect. Another obstacle can be lingering doubts and uncertainties about the best possible course of action: What are the most economically desirable and the most technically and politically feasible ways of producing the good?

21. Similar problems have, of course, plagued other areas of international cooperation, including, for example, the environmental field. Policy makers in this field have effectively mobilized the global epistemic community, in the form of the Intergovernmental Panel on Climate Change, to help to reduce uncertainty. A similar initiative could perhaps be taken in the financial area, possibly as a follow-up to the forthcoming Financing Conference.

IV. Capacity-building in developing countries is critical to achieving the objective of financial stability and market efficiency. The seigniorage earned by the central banks of industrial countries could be an appropriate funding source.

22. Capacity-building is important in order to root the design of the international financial architecture in national development concerns, to foster broad participation in international financial policy-making, and through enhanced participation, to achieve a fairer sharing of the net-benefits of international cooperation.

23. If we assume that less segmented markets are more efficient markets and that the goal is development for all, we can look at financial markets and their supportive public-policy institutions as a global network. The overall quality of the network will depend on that of its weakest links as well as on its size, i.e., how global it is. Creating a well-functioning network of financial markets that indeed serves development thus requires bringing in and strengthening the emerging and as-yet-to-emerge markets. Put differently, it requires development assistance, notably technical assistance, to these markets.

24. The importance of such assistance is increasingly being emphasized. A number of aid agencies, bilateral and multilateral, are developing assistance programmes.[19] The existing needs are enormous. And similar capacity-building challenges, of course, exist in respect of other international regimes, including that for trade or global environmental concerns. But then, remember Eichengreen's question above of how to prioritize between meeting the urgent needs of poverty reduction now and investing in the longer-term development of the global financial system.

25. Looking at this challenge through the GPG lens suggests that building a global financial system is in the interest of *all* developing and industrial countries. The higher the rate of industrial-country actors'

[19] See, for example: IMF (2001), Swedish International Development Agency (2001); World Bank (http://www.worldbank.org/whatwedo/services.htm); and United Kingdom (2000). Gordon Brown, the UK Chancellor of the Exchequer, furthermore announced a forthcoming "multi-million pound facility for technical assistance to enable developing countries to meet these international standards" (United Kingdom, 2001).

investments abroad, the more this holds true. Hence, it would be justified and reasonable to finance the strengthening of the global financial system not out of aid resources, i.e., official development assistance (ODA) funds, but instead to augment such funds with additional contributions, especially from the central banks of the richer industrial countries. Financial instability risks reducing the value (purchasing power) of any country's money. Hence, each country's monetary authority should have an interest in removing existing factors of potential instability. It could opt to finance its contribution to the endeavour (this at least in the case of money-issuing countries/country groupings) from seigniorage it earns. The rationale would be that the *full* cost of creating sound money is higher than conventionally thought, viz. higher by the amount required for capacity-building, and possibly, other international cooperation efforts.

26. In fact, bilateral precedents do exist. For example, the United States Department of Treasury runs a technical assistance programme to assist transition economies and developing countries in financial market development.[20] And an interesting multilateral example of a network with self-improvement arrangements is the Quality of Service Fund for postal-service networks established by the Universal Postal Union.[21] The rationale for assistance in this case is not — or not merely — one of aid, i.e., charity or moral concern about poverty. Rather, it is one of unleashing positive network externalities: investing in making the network more useful for all, with a positive net benefit for all members, even those who foot the bill for the investment in network improvement.[22]

27. Of course, the financing requirements for capacity-building constitutes only a fraction of the total amount of the resources needed to produce the GPG "financial stability and market efficiency". Other requirements could relate to improving the availability of official liquidity in distress conditions (e.g., through appropriate modifications of the IMF Contingency Credit Line), or to enhancing the availability of official development finance, in particular for poorer countries as yet unable to attract sufficient private flows. It would be important for each building block to identify the most appropriate funding source and modality.

Conclusion

28. This paper has explored some of the additional policy insights to be gained when examining the issue of financial stability and market efficiency through the GPG lens. The main argument has been that the GPG lens helps to change the concerned actors' incentive structure and motivation to act. It also reminds us that the adequate provision of good "financial and market efficiency" requires international cooperation. Under-provision will make everyone worse off; and hence, it is in the interest of all to find effective ways of cooperating.

29. The paper suggest four concrete ways of achieving more successful cooperation in the finance area: (1) to root the design of international cooperation in national policy goals and conditions and to look at GPGs as public goods that now require international cooperation but still ought to have positive utility for all nationally; (2) to encourage broader participation in international financial policy-making as a means to reduce collective-action and information as well as burden-sharing problems; (3) to engage more actively the epistemic community in exploring possible production paths of the GPG "financial stability and market efficiency", notably the complementarities

[20] See United States of America (2001), the Department of Treasury, Office of Technical Assistance.

[21] The Fund comes into effect in July 2001. It is part of a new terminal due system (system of compensatory payments between postal administrations), where developed countries' terminal dues are increased by 7.5 per cent to generate funds for the Quality of Service Fund. The money will be paid out to developing countries in the form of specific quality-of-service improvement projects. The Fund is estimated to generate some US$ 20 million annually (Universal Postal Union 2001).

[22] Such a network approach to, and rationale for, operational development cooperation will, together with other possible modalities of financing GPGs, be discussed in a forthcoming UNDP-supported publication, entitled "Providing Global Public Goods; Making Globalization Work for All". For further information see, http://www.undp.org/globalpublicgoods.

between national, regional and international-level measures; and (4) to finance needed capacity-building in developing countries out of the seigniorage earned by the central banks of industrial countries — as an integral part of their efforts to provide sound money.

30. Past progress in terms of democracy, transparency and accountability have strengthened people's — *the public's* — development expectations worldwide, including their expectation that public goods, which are public in consumption and often affect all, should have more evenly distributed utility for all, not benefits for some and costs for others. Therefore, it is not only useful to look at financial stability and market efficiency through the GPG lens; it may even be mandatory in order, as the Secretary-General emphasized, to lessen the backlash against globalization, and help make the process work for all people.[23] The forthcoming Financing Conference provides the international community with an opportunity to meet this challenge.

[23] For the report of the Secretary-General to the Preparatory Committee for the High-level International Intergovernmental Event on Financing for Development, see A/AC.257/12.

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